

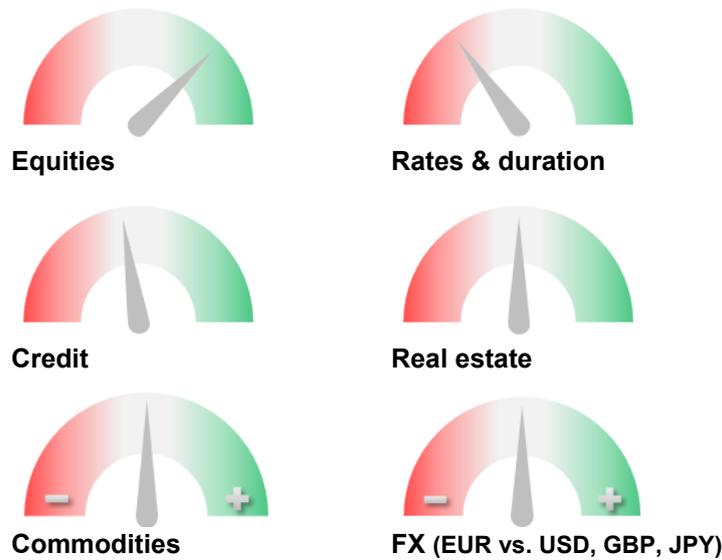


ASSET ALLOCATION MONTHLY

BNPP AM – Multi Asset, Quantitative and Solutions (MAQS)

THE RETURN OF THE US INFLATION THREAT

Asset allocation overview:



Christophe MOULIN
Head of Multi Asset, MAQS
christophe.p.moulin@bnpparibas.com
+33 1 58 97 23 61

Guillermo FELICES
Head of Research and Strategy, MAQS
guillermo.felices@bnpparibas.com
+44 20 7063 7196

Colin HARTE
Head of Research, MAQS
colin.harte@bnpparibas.com
+44 20 7063 7277

Maxime DAVID
Research Analyst, MAQS
maxime.h.david@bnpparibas.com
+44 20 7063 7270

SUMMARY:

- As in February, US Treasury yields rose to the point where they ended up rocking markets, but this time the disruption was more visible in the US dollar and emerging markets than in equity markets.
- We see several factors for the rise: (i) US inflation and crude oil prices hit 2018 highs in April, (ii) US macroeconomic data have been robust enough for the US Federal Reserve to continue normalising its interest-rate policy, and (iii) rates markets have become more concerned about US Treasury debt issuance.
- The bar is quite high for further interest-rate increases in the near term, but when policy tightening does resume, we think this will not keep equity markets from rallying as long as the growth backdrop remains solid.
- The stronger USD reflects disappointing economic activity data in the G10 and emerging markets compared to the US. This is consistent with markets pricing in reduced expectations of central bank policy normalisation in Europe and Japan.
- Further USD strength is possible, but we doubt it can persist in the medium term unless the prospects for growth in the US continue to decouple from those for the rest of the world.

ASSET ALLOCATION:

- Our key asset allocation views have not changed. We remain long European equities, where we see more attractive valuations and good earnings fundamentals, while we remain underweight government bonds, mainly by being short German Bunds.
- In April, we took a long position in US bank equities versus the overall US index. This relative value trade should do well as banks typically benefit as interest income rises and as the economic recovery matures.



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MARKET REVIEW APRIL 2018: RISING US YIELDS SUPPORT USD

Global equities had a good start to the month before facing new investor concerns about rising bond yields and US inflation, in line with what happened at the end of January. The nerves were more pronounced in the US where the 10-year yield broke above 3% for the first time in four years.

The S&P 500 equity index still ended the month in modestly positive territory, in part due to supportive earnings reports. European and Japanese equity markets did better, catching up after lagging since the beginning of the year.

The UK was among the top performers, returning more than 6%, on the back of a weaker currency. It was outranked only by the Athens stock exchange, which rose by about 10% on constructive fiscal news. Emerging markets lagged the pack mainly due to the stronger US dollar.

The market tensions were perhaps more evident in currency than in equity markets. The US dollar started strengthening after a prolonged period of weakness that began in January 2017. The US dollar index (DXY) rose by 2%, its best monthly performance since November 2016. In the UK, sterling peaked at 1.43 versus the US dollar before dropping by 4% in the second half of April due to disappointing macroeconomic figures (weak retail sales, lower-than-expected GDP growth and falling CPI inflation).

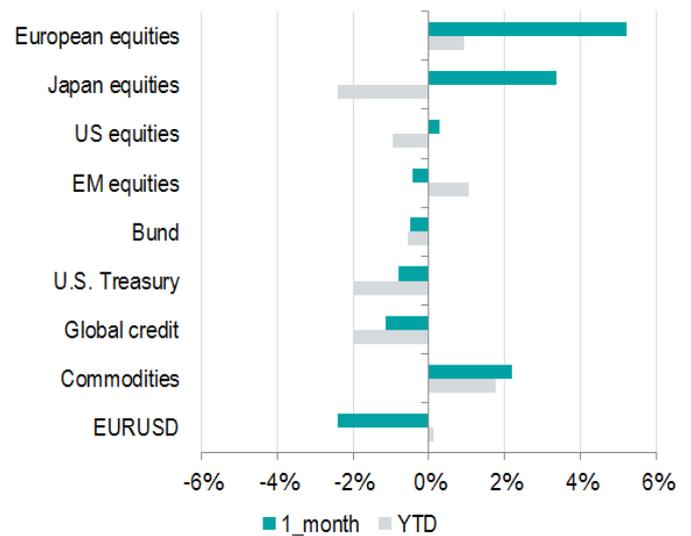
Fixed-income markets were generally down over the month as global yields rose. The sell-off in US government bonds pushed yields above 3%. German Bunds sold off as well, but to a lesser extent as ECB President Draghi maintained a dovish tone and showed no inclination to begin normalising monetary policy.

In credit markets, investment-grade followed suit, retreating by 1% in the US. But it was flat in Europe. However, high-yield markets outperformed partly thanks to a sharp rally in energy stocks.

Despite calls by Germany’s Merkel and France’s Emmanuel Macron to hold off on further sanctions on Iran, the Trump administration appeared increasingly hawkish towards this OPEC oil producer. West Texas Industrial crude oil rose by about 8% over the month, also pushed higher by statements by Saudi Arabia in support of USD 80 per barrel oil ahead of next year’s Saudi Aramco IPO.

Geopolitics also affected industrial metals prices: Russian aluminium producer Rusal was hit hard by US sanctions and sent aluminium prices up by almost 30% before cooling down to end the month up 12%.

Figure 1: European and Japanese equities have been catching up with the US equities



Source: Bloomberg, BNPP AM, as of 1 May 2018

WHAT WAS BEHIND THE RISE IN US YIELDS? CAN IT PERSIST?

There are several reasons for the rise in US Treasury yields, in our view. To start with, both break-even inflation and real rates rose in April. Market-based inflation expectations were supported by higher reported US core inflation and by higher oil prices (Figure 2). Core inflation rose to above 2% after being subdued for several months, whereas WTI oil prices rallied to USD 68 a barrel supported by strong demand and geopolitical concerns around Iran.

Figure 2: Oil prices support US inflation expectations



Source: Bloomberg, BNPP AM, as of 30 April 2018

In addition, markets appeared to be increasingly concerned about the supply of US Treasury bonds that will be needed to finance the Trump

administration's fiscal expansion. Such issuance concerns had already hit the market in Q1 and it is likely pushing US yields higher. Beyond these supply concerns, recent US macroeconomic data has been solid enough to convince the market that the Fed will continue raising interest rates in a gradual and steady way.

We do not see higher US rates as an impediment for a continued equity market rally. Indeed, as we discussed in the March Asset Allocation monthly, it is quite normal to see strong equity performance during Fed tightening cycles. What changes is the drivers of the outperformance, with earnings growth doing most of the legwork rather than P/E multiple expansion. In other words, as long as the growth backdrop is supportive (as it is now) and the rise in yields is contained, any equity corrections should be limited. Therefore they can be seen as buying opportunities.

The latest US growth data was not spectacular: in Q1, GDP grew by 2.3%, down from 2.9% in Q4 2017. However, it is too early to worry about a turn in the US economic cycle. If anything, the Q1 earnings season has been encouraging, with 77% of companies beating analyst earnings estimates (among the 32% that have reported Q1 results so far).

FINALLY, SOME USD STRENGTH. HOW MUCH FURTHER CAN IT GO?

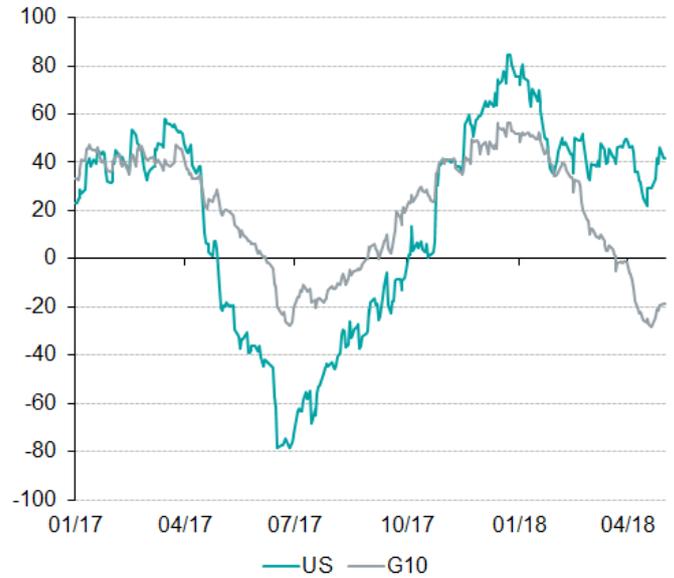
Figure 3: USD strengthens, notably versus emerging market currencies



Source: Bloomberg, BNPP AM, as of 1 May 2018

After months of weakness relative to other major and emerging market currencies, the US dollar has been showing signs of strength (Figure 3). The most likely explanation for its strength versus other major currencies is that the cyclical recoveries in Europe and Japan have fallen short of market expectations, whereas the opposite has been true for the US (Figure 4).

Figure 4: Macroeconomic surprise indicator stays positive in the US, while it disappoints in other G10 economies (index, 0=no surprise)



Source: Bloomberg, BNPP AM, as of 01 May 2018

In other words, the data in Europe and Japan has not been strong enough to convince investors that the ECB and the Bank of Japan will sound more hawkish anytime soon. By contrast, the solid, if unspectacular, data in the US has been enough for the rates market to continue to price in higher US front-end yields (Figure 5).

This contrasts with European markets where the growth prospects have softened and core inflation has remained subdued. In the eurozone, for example, cyclical indicators such as the PMIs have weakened after months of strength. In the UK, growth has disappointed. Q1 GDP growth fell to 1.2% YoY compared to consensus expectations of a 1.4% rate. The rates markets is now pricing out a BoE hike in May.

Figure 5: US two-year yields rose in April, decoupling from yields in other regions (in bp)



Source: Bloomberg, BNPP AM, as of 1 May 2018

Will this US dollar strength continue? We believe that some of the strength reflected the weaker G10 (ex-US) data, but it is too early to call for a sustained rally. After all, the recoveries in Europe and Japan are less advanced than in the US and the ECB and the BoJ have more asymmetric interest-rate paths given their aggressive monetary policy stances relative to the Fed.

The US dollar appreciation has been more aggressive vs. emerging market currencies. A strong dollar is usually a worry for emerging markets because it may reflect rising US yields which can cause capital to flow out of emerging markets and into US markets. A stronger US dollar is also associated with weaker commodity prices, which tend to help emerging market commodity exporters. Finally, a stronger dollar may trigger a selloff in emerging equities and local currency debt as dollar-based investors worry about currency losses.

The moves in emerging currencies have also been sharp because of consensus positions in these currencies resulting in investor complacency. US dollar strength against emerging currencies may persist in the near term as the consensus positions are reassessed. But we believe it is too early to call for prolonged strength. After all, the cycle in emerging economies is strong. It also lags the G10 cycle. Emerging currencies are not being seen as expensive apart from currencies in emerging Asia and, finally, the carry on emerging currencies is still very attractive, in our view.

ASSET ALLOCATION

Our key asset allocation views have not changed. We remain long **European equities**, where we see more attractive valuations and good earnings fundamentals. We are also long **Japanese equities** (currency unhedged), where we see material upside to earnings growth relative to the consensus expectations. A stronger USD vs. EUR and JPY has helped to unlock value in these positions as corporate earnings typically benefit from a weaker EUR and JPY.

We remain underweight **government bonds**, mainly by being short German Bunds.

We implemented a new trade in April: long **US bank equities** versus the overall US S&P 500 index. This relative value trade should do well since banks typically benefit as interest income rises and the economic recovery matures (Figure 6).

Figure 6: We expect the US banks to outperform the S&P 500



Source: Bloomberg, BNPP AM, as of 1 May 2018

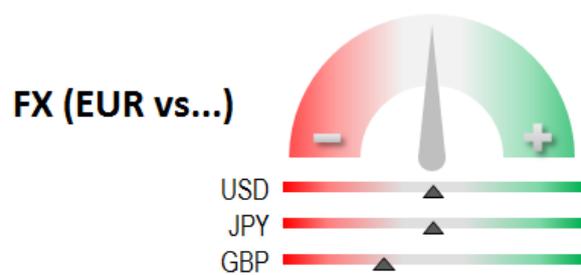
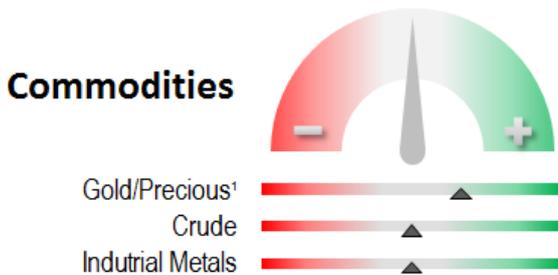
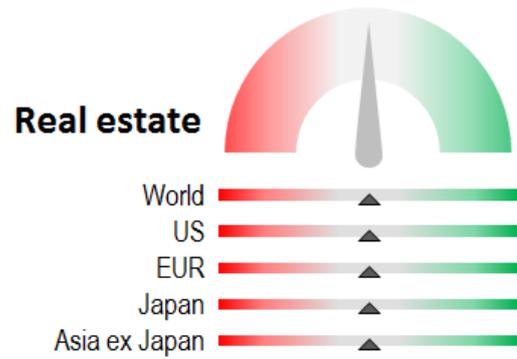
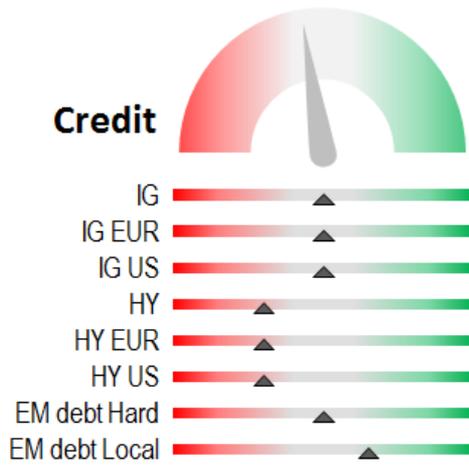
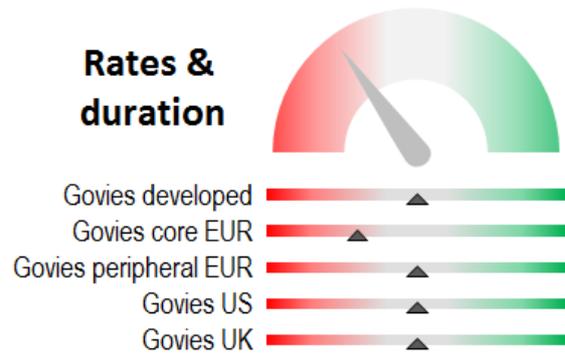
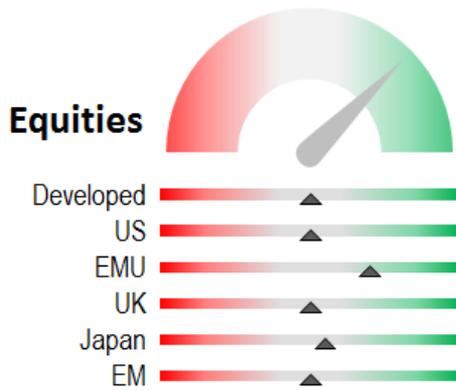
Finally, we closed our long **US real estate** position versus US Treasuries. In an environment of rising US yields and after a protracted period of underperformance by REITs, we deemed it prudent to close the position as our conviction for a catch-up has been weakening. The effects of the structural shift in the retail industry due to the rise of online shopping may last longer than expected, notably the effects on discounts to net asset value. Some REITs are positively impacted, in particular industrial ones that invest in warehouses used to pack and ship goods to online shoppers. However, they account for only 10% while retail REITs, which are suffering from shopping disruptions, represent almost 25% of the US market. Even though valuations look attractive, the asset class has failed to bounce higher so far.

STRATEGIC OVERVIEW OF KEY POSITION CHANGES IN APRIL 2018

The BNPP AM MAQS team made the following strategic calls:

- | | | |
|---|---------------|-------------------|
| LONG US BANKS VERSUS US EQUITIES | OPEN | 18/04/2018 |
| <ul style="list-style-type: none">We have tilted our portfolios towards US banks which should outperform as yields rise. | | |
| LONG US REITS VERSUS US TREASURIES | CLOSED | 11/04/2018 |
| <ul style="list-style-type: none">We closed the position due to our fading conviction in an environment of rising US yields that could hurt US REITs further. | | |

ASSET ALLOCATION DASHBOARD¹



¹: only selective portfolios

¹ The dashboard shows the asset allocation in our portfolios and reflects the decisions of the Investment Committee of the Multi-Asset team at MAQS.

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